Barclays and Canada Trustco: Further Comment from a UK Perspective

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ABSTRACT

The judicial function in tax cases is to construe tax legislation and give effect to the parliamentary purpose that emerges from the statutory language. A statutory general anti-avoidance rule (GAAR) may affect the process of judicial reasoning by creating a framework within which that reasoning is conducted. Ultimately, however, the outcome of that reasoning, whether conducted under a statutory GAAR or as part of judicially developed interpretive techniques, will depend upon the clarity of the legislative purpose. If the legislation does not have a sound policy foundation, it is unlikely to provide the necessary clarity to resolve whether particular conduct should be characterized as abusive tax avoidance (and therefore rendered tax-ineffective). A statutory GAAR cannot supply a policy foundation for tax legislation where none can be discerned under the basic tax legislation.

KEYWORDS: TAX AVOIDANCE ■ GAAR ■ LEASING ■ TAX POLICY ■ STATUTORY INTERPRETATION

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THE UNDERLYING POLICY ISSUE

Central to the decisions of the House of Lords in *Barclays*[1] and the Supreme Court of Canada in *Canada Trustco*[2] is the policy of the tax legislation under consideration in the appeals. Commentators on tax avoidance frequently overlook the fact that tax avoidance is a function of the tax base. If there is no coherent policy behind

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1 [2004] UKHL 51; (2004), 76 TC 446.

2 2005 SCC 54.

what is sought to be taxed, it is quite unlikely that the legislative definition of the tax base will be clear. The courts, whose function it is to interpret that legislation, will not be able to supply coherence where policy makers themselves have failed to do so. Overlaying the legislation with a statutory general anti-avoidance rule (GAAR) will not resolve that fundamental policy problem any more than a judicial anti-avoidance doctrine will.

Barclays and *Canada Trustco* involved similar defeased leasing transactions. In effect, the lessor acquired assets that would deliver the tax allowances designed to reduce the asset owner's tax bill. The lessor then leased the assets back to the seller on terms that largely eliminated any real risk to the lessor in the transaction. In each case, it was the elimination of the lessor's risk that was said to offend the purpose or policy of the legislation. It is not clear, however, why this should be so. The fact that the taxpayer won in both the United Kingdom and Canada should therefore come as no surprise.

Accountants deal with finance leasing arrangements according to their economic and financial substance, recognizing that such transactions are no more than loans in another guise. Neither the Canadian nor the UK tax system adopted that entirely sensible recognition of substance over form. Instead, both systems followed legal form and conferred tax allowances on the legal owner of the equipment. Once the decision has been made not to follow the economic substance of the arrangement, especially when the substance reflects the reality of the financing involved, it becomes rather difficult to say why one legal owner should be entitled to tax allowances but another should not on the basis of how the parties have chosen to finance the transaction.

If there is a policy objective that underlies finance leasing provisions based on legal ownership rather than the substance of the transaction, it is that the government permits the economic owner of the asset to transfer the benefit of tax allowances to someone who is better placed to use them to reduce his tax bill and who can then therefore offer better financial terms to the true owner. This is a straightforward tax incentive. In the face of such an incentive, it is rather difficult to articulate a sensible reason why a legal owner should be entitled to the allowances if he accepts some risk but should be denied them if he takes security or leases on terms that largely eliminate his risk. There is no sensible definition of "risk," or of the particular degree of risk that these transactions should involve, that is in any way related to the nature of the tax incentive that underlies these particular provisions of the tax code.

Governments and legislatures are, of course, entitled to attach whatever conditions they wish to the incentives that they choose to confer under the tax system. There is, however, a fundamental tension between the desire to particularize in ever more detailed terms the conditions that taxpayers must satisfy if they are to qualify for the incentive and a more general specification that, even if those conditions are satisfied, the incentive should not be available in "undeserving" cases. The criteria adopted to identify such cases often relate to the commercial nature of the transaction or to the motivation of the parties involved. Did they have a commercial purpose, or was the transaction wholly tax-motivated? Tax incentives are designed, however, to alter taxpayers' ordinary behaviour. It is hardly satisfactory, therefore, to focus on the behavioural response to the incentive as a possible reason for denying the incentive. That approach involves being able to identify some behavioural responses as "use" and others as "misuse" or "abuse"—or, in the terminology of the UK debate, being able to distinguish acceptable tax mitigation from unacceptable tax avoidance. Distinguishing such concepts involves applying value judgments, which are likely to be common or shared only where there is a clear policy framework to indicate the particular objectives that the incentive is designed to achieve.

THE UK APPROACH TO TAX AVOIDANCE

In recent years, there has been a proliferation of general anti-avoidance language attached to specific parts of the UK tax code. To date, however, the United Kingdom has eschewed an overarching statutory general anti-avoidance provision. The capital allowances legislation has for many years contained provisions designed to limit the availability of allowances to finance lessors. The Revenue attack on the *Barclays* transaction was not based on these provisions—which Barclays has carefully skirted—but on the judicial anti-avoidance doctrine first applied in *W.T. Ramsay v. Inland Revenue Comrs*.[3]

In the *Barclays* case, on the face of it, there had been a circular transaction. In summary, Barclays bought a gas pipeline from the Irish Gas Board, leased it back to a subsidiary of the Gas Board, and took a bank guarantee from Barclays Bank. The Irish Gas Board guaranteed its subsidiary's obligations to Barclays and deposited the sale proceeds with a Barclays subsidiary as security. Payments were to be made under the usual financial schedule, ensuring that Barclays would be paid as any secured lender would expect to be paid. The first instance tax tribunal and the High Court judge agreed with the Revenue that the *Ramsay* principle applied to defeat a circular transaction entered into solely to obtain a particular tax result. They appear to have applied the *Ramsay* principle in a way of which one of its most enthusiastic judicial supporters, Lord Templeman,[4] would have approved, but which had been rejected by the House of Lords in *MacNiven v. Westmoreland Investments Ltd.*[5]

In *Westmoreland*, the Revenue formulated the *Ramsay* principle in the following terms:

> When a court is asked
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> (i) to apply a statutory provision on which a taxpayer relies for the sake of establishing some tax advantage

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3 [1982] AC 300 (HL).

4 See Lord Templeman, "Tax and the Taxpayer" (2001) vol. 117, no. 4 *The Law Quarterly Review* 575-88.

5 (2001), 73 TC 1 (HL).

(ii) in circumstances where the transaction said to give rise to the tax advantage is, or forms part of, some pre-ordained, circular, self-cancelling transaction

(iii) which transaction though accepted as perfectly genuine (i.e. not impeach as a sham) was undertaken for no commercial purpose other than the obtaining of the tax advantage in question

then (unless there is something in the statutory provisions concerned to indicate that this rule should not be applied) there is a rule of construction that the condition laid down in the statute for the obtaining of the tax advantage has not been satisfied.[6]

As Lord Hoffmann noted,

> My Lords, I am bound to say that this does not look to me like a principle of construction at all. There is ultimately only one principle of construction, namely to ascertain what Parliament meant by using the language of the statute. . . . But [the Revenue's] formulation looks like an overriding legal principle, superimposed upon the whole of revenue law without regard to the language or purpose of any particular provision, save for the possibility of rebuttal by language which can be brought within [the] final parenthesis. This cannot be called a principle of construction except in the sense of some paramount provision subject to which everything else must be read. . . . But the courts have no constitutional authority to impose such an overlay upon the tax legislation.[7]

As this indicates, the *Ramsay* principle is now firmly established as a principle that brings the construction of UK tax statutes into line with the non-formalist methods of interpretation applied to legislation more generally. In particular, the *Ramsay* principle freed the courts to interpret the relevant legislation in the context of the "real" transaction rather than by reference to a sterile step-by-step approach. In confirming the true scope of the *Ramsay* principle, and "the need to avoid sweeping generalizations about disregarding transactions undertaken for the purpose of tax avoidance," the House of Lords in *Barclays* approved what Ribeiro PJ had said in *The Collector of Stamp Revenue v. Arrowtown Assets Ltd.*:

> [T]he driving principle in the *Ramsay* line of cases continues to involve a general rule of statutory construction and an unblinkered approach to the analysis of the facts. The ultimate question is whether the relevant statutory provisions, construed purposively, were intended to apply to the transaction, viewed realistically.[8]

THE CANADIAN APPROACH TO TAX AVOIDANCE

To a British lawyer, there is much in the *Canada Trustco* decision that strikes a familiar chord. In particular, the repeated emphasis on statutory interpretation and the need to identify the object, spirit, or purpose of the legislation corresponds to

6 Ibid., at paragraph 28.

7 Ibid., at paragraph 29.

8 [2003] HKCFA 46, at paragraph 35.

the approach in *Barclays*. This should not be surprising. There is no particular reason why the existence of a GAAR should alter the judicial approach to what is, after all, only another piece of legislation. Admittedly, the Supreme Court has to address the question of the relationship between the specific provision of the Income Tax Act and an overarching rule such as the GAAR—a task that is not imposed on the House of Lords. Nevertheless, both courts face fundamentally similar issues.

For the Canadian court, the question is: Assuming (as one must) that all the conditions of the specific legislation are satisfied, under what circumstances ought the court nevertheless to deny the taxpayer the benefit of those provisions? For the UK court, the question is: Having regard to the transactions viewed realistically, does the taxpayer indeed satisfy the terms of the legislation, as purposively construed? The former approach may perhaps lead to a more formalist interpretation of specific legislation subject to the general purposive overlay of the GAAR; the latter eschews the formalist approach to the legislation generally. However, the outcome by each of these slightly different routes may not differ—other than is inevitable when more than one answer is possible and there is no clear underlying policy to guide which should be chosen.

Of course, a government could be as direct as to enact an appropriately formulated GAAR declaring that it is entitled to deny the benefit of any provision, if it chooses to do so, when it does not like the look of a taxpayer or his particular transactions. That, however, would transgress what is usually regarded as the bounds of the rule of law. Accordingly, if the answer is not to be wholly a matter of Revenue discretion (circumscribed by the application of administrative law to keep that discretion in check), it must ultimately depend on a judicial inquiry into the facts against the background of the particular statutory provisions. That inevitably involves an inquiry into the policy framework of the legislation. Thus, the Supreme Court's conclusions in paragraphs 40 to 42 of its decision have much in common with Lord Hoffmann's remarks in *Westmoreland*. If we do not necessarily agree with the outcome that the approach produces, the difference is as likely to arise from the absence of any clear policy framework for the legislation as from a weakness in judicial reasoning.

MATHEW AND SCOTTISH PROVIDENT

Neither *Barclays* nor *Canada Trustco* should be viewed in isolation. The House of Lords and the Supreme Court each handed down a second decision that should be read in conjunction with these cases. *Inland Revenue v. Scottish Provident Institution*[9] involved cross-options designed to exploit the 1996 transition to the United Kingdom's new loan relationship provisions by creating an untaxed profit prior to their introduction and an allowable loss after their introduction. The House of Lords had little difficulty in using the *Ramsay* principle to defeat the arrangement through

9 [2004] UKHL 52; (2004), 76 TC 538.

an appropriate construction of the relevant legislation. In *Mathew v. The Queen*,[10] the Supreme Court denied the taxpayer the benefit of losses bought through a partnership structure in an arrangement designed to transfer the benefit of losses from the insolvent company that had incurred them to taxpayers with the taxable income needed to offset them.

These two cases are not directly comparable as *Barclays* and *Canada Trustco* are. The House of Lords' reasoning in *Scottish Provident* had to be based on the construction of a particular statutory definition of a "debt contract," having regard to the reality of the transactions entered into, to see whether the cross-options were of a type contemplated by the definition. The Supreme Court, by contrast, was able to focus more directly on the policy of the legislative provisions in question, to see whether the transaction was of a type contemplated by those provisions. However, as this briefest of summaries suggests, both cases illustrate that when a court asks a relatively straightforward question—here, whether the transaction or arrangement at issue is of a type that Parliament intended to benefit from the relevant provisions—and the court can discern an underlying purpose to those provisions, it will be prepared to provide a relatively straightforward and robust answer.

CONCLUSION

In 1998, the UK government consulted on the possibility of introducing a GAAR but decided not to do so at that time. Subsequently, although specific and more general anti-avoidance legislation has proliferated in the United Kingdom, no overarching rule has been enacted comparable to Canada's GAAR. However, recent discussions in the United Kingdom have turned again to a GAAR, to consider whether it might better achieve the government's objectives of curbing activities characterized as tax avoidance.

Both *Canada Trustco* and *Mathew* illustrate that the reasoning under Canada's GAAR necessarily follows a distinct path, reflecting how the rule is drafted—in particular, the "layered tests" encompassed within it, and the burden of proof that it imposes on both taxpayers and the government. As the Canadian provision indicates, however, a GAAR will never be a complete solution to taxpayer behaviour characterized as avoidance so long as it requires the courts to apply a meaningful degree of scrutiny in order to form an opinion on questionable arrangements. In particular, the legislation must have a coherent policy rationale, because, where none exists, it will be very difficult for judges to devise one. In this respect, the court's approach in *Canada Trustco*, that the burden lies with the government to explain what the policy is, seems entirely justified.

The lesson from these recent cases for governments in the United Kingdom and Canada is that the overriding requirement for minimizing tax avoidance is sensible tax policy, and that this will bring its own rewards in court.

10 2005 SCC 55.